

Public Nontraded Mortgage REITs— Issues and Opportunities

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Rob Bergdolt and Bob Le Duc provide an overview of the securities and tax environment in which a public nontraded mortgage REIT must operate, and a summary of certain advantages that public nontraded mortgage REITs have over their publicly traded counterparts.

Introduction

There are approximately 170 publicly traded real estate investment trusts (REITs) listed on U.S. stock exchanges with a total equity capitalization in excess of \$380 billion.¹ These REITs include equity REITs, which focus on owning rental real estate; mortgage REITs, which invest in mortgages and related debt obligations²; and hybrid REITs, which invest in both real estate and debt instruments. Additionally, there are hundreds of “private” REITs, which do not trade on any exchange and do not file reports with the Securities and Exchange Commission (SEC).

In between “publicly traded” and “private” REITs is a class of REITs that conducts public offerings of equity securities registered with the SEC and the states and files reports with the SEC, but does not trade on any exchange—so-called public nontraded REITs.³

Although there are fewer than 20 significant sponsors of public nontraded REITs, these REITs raise substantial amounts of capital. In 2007, experts estimate total public nontraded REITs received public

offering proceeds of \$11.5 to \$12 billion.⁴ To date, these nontraded REITs have focused on equity interests in real estate. However, due to peculiarities of nontraded REITs and some quirks in the Internal Revenue Code of 1986, as amended (“the Code”),⁵ public nontraded REITs have certain advantages over publicly traded REITs in the mortgage REIT context. Specifically, public nontraded REITs generally have the opportunity to utilize the “temporary investment of new capital” exception under the Code in a robust manner not typically available to publicly traded REITs. In addition, although careful consideration must be given to the requirements of the Investment Company Act of 1940 (“the ‘40 Act”), the holdings of the vast majority of public nontraded REITs today are such that they should be able to utilize the “new capital” exception while continuing to remain exempt from registration under the ‘40 Act.

Mortgage REITs in General

Mortgage REITs usually do not own significant amounts of rental real estate, but rather hold debt obligations of one sort or another: whole mortgages, A-notes, B-notes, second mortgages, mortgage-backed securities (MBS) including agency MBS (e.g., MBS issued and/or guaranteed by the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and

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the Federal Home Loan and Mortgage Corporation (Freddie Mac)), mezzanine loans and participations of all sorts in these and other debt investments.

Many mortgage REITs do not originate their own investments to any significant extent, but rather simply purchase existing REIT-qualified debt obligations from third parties. Some mortgage REITs, however, do engage in significant loan sourcing and origination activities, although this is typically conducted through a taxable REIT subsidiary (TRS) to manage certain tax issues explained in more detail below.⁶

Leverage is an important component of virtually all mortgage REITs' investment strategies. In addition to standard credit lines and warehouse financing arrangements, mortgage REITs often obtain additional capital *via* collateralized debt obligation (CDO) offerings or other securitizations, repurchase agreements (repos), use of real estate mortgage investment conduits (REMICs) and other arrangements.

Investment Company Act of 1940

Under the '40 Act, certain entities must register as investment companies. Such registration is expensive and would cause the registrant to be subject to restrictions regarding corporate governance, capitalization and other matters. These restrictions are generally incompatible with the business plans of mortgage REITs in general and public nontraded mortgage REITs in particular.

The '40 Act generally defines an investment company as any issuer that owns investment securities having a value exceeding 40 percent of the value of the issuer's total assets on an unconsolidated basis (excluding cash and government securities). "Investment securities" are very broadly defined and include many indirect interests in real estate owned by mortgage REITs, including mezzanine loans, mortgage-backed securities and interests in entities that are not majority-owned subsidiaries of the holder. Given the breadth of this definition, mortgage REITs often seek to rely on the exception from the definition of an investment company set forth in Section 3(c)(5)(C) of the '40 Act, which excepts from the definition of an investment company those who are "primarily engaged" in "acquiring mortgages and other liens on and interests in real estate."

The SEC takes the position that to be "primarily engaged," for purposes of Section 3(c)(5)(C), an issuer must invest at least 55 percent of its assets in mortgages and other liens on and interests in real estate ("quali-

fying assets"). An additional 25 percent of the issuer's assets must also be in "real estate related assets," with the 25-percent figure reduced to the extent the 55-percent test is exceeded (in other words, a mortgage REIT seeking to rely on the Section 3(c)(5)(C) exemption with 60 percent of its assets represented by whole mortgages need only have an additional 20 percent of its assets be "real estate related").⁷

Mortgage REIT "Qualifying Assets"

It is not always clear when assets (other than whole mortgages) qualify under the 55-percent test. SEC comments to recent mortgage REIT securities filings and no action letters indicate that specific requirements must be met in order for certain common real estate-based debt instruments to meet the 55-percent test (e.g., participations in mortgages, MBS and mezzanine debt).

The SEC has concluded that a participation interest in a mortgage loan is a qualifying asset if the loan is fully secured by real property, *i.e.*, the value of the property is greater than the principal owed on the mortgage loan, and the participation interest is sufficient to give the holder the right by itself to foreclose on the mortgage loan in the event of a default.⁸ With respect to B-notes, it appears from the SEC registration process that B-notes are qualifying assets if the holder has "the unilateral right to (i) instruct the servicer to foreclose on a defaulted mortgage loan, (ii) replace the servicer in the event the servicer, in its discretion, elects not to foreclose on such a loan, and (iii) purchase the A Note in the event of a default on the mortgage loan."⁹

With respect to MBS, "whole pool" certificates will generally be treated as qualifying assets.¹⁰ A whole pool certificate represents all of the beneficial interest in a pool of mortgages. However, partial pool certificates will generally not be treated as a qualifying interest unless (i) the investor directly, or through the ability to appoint a special servicer, has foreclosure rights on the underlying mortgages; (ii) the investor owns 100 percent of the first-loss class; and (iii) the pool does not contain more than 15 percent of "real estate related notes," that is, notes backed by mortgages with respect to which the special servicer does not have the unilateral right to foreclose.¹¹ To the extent the pool contains any "real estate related notes" but less than 15 percent, only a prorated portion of the asset will satisfy the 55-percent test.¹² With respect to other classes of partial pool certificates, they will generally

only count as qualifying assets if, with respect to other classes, (i) the class is not investment grade; (ii) the investor acquires 100 percent of such class and 100 percent of the controlling class; (iii) each such class is contiguous for credit purposes with the controlling class or other qualifying class; and (iv) each such class is entitled to exercise all rights of the initial controlling class, including foreclosure rights, if it becomes the controlling class.¹³

In the real estate industry, mezzanine debt is typically the debt of a special purpose entity (SPE) that owns all the equity interests in another SPE that owns commercial real property subject to a mortgage loan secured by the property. The SPEs may not engage in any other business. The mezzanine borrower pledges its ownership interest in the property-owning SPE to the mezzanine lender as collateral for the mezzanine loan. Such loans will count as a qualifying asset if (i) the loan is made specifically and exclusively for the financing of real estate; (ii) the loan is underwritten based on the same considerations as a second mortgage and after the mezzanine lender performs a hands-on analysis of the property being financed; (iii) the lender exercises ongoing control rights over the management of the underlying property; (iv) the lender has the right to cure defaults readily or purchase the mortgage loan in the event of a default on the mortgage loan; (v) the true measure of the collateral securing the loan is the property being financed and any incidental assets related to the ownership of the property; and (vi) the lender has the right to foreclose on the collateral and through its ownership of the property-owning entity become the owner of the underlying property.¹⁴

Real Estate Related Assets

With respect to the 25-percent test, the SEC has not defined "real estate related assets." However, based on the disclosure in recent SEC-reviewed prospectuses for mortgage REITs, we believe that investments typical of mortgage REITs are not likely to be challenged as being other than "real estate related."

Calculating Section 3(c)(5)(C) Compliance

Complicating Section 3(c)(5)(C) compliance is the method of calculating the 55-percent/25-percent tests. Conversations with SEC staff members suggest that the SEC measures Section 3(c)(5)(C) compliance on an unconsolidated basis. This position has important consequences to those mortgage REITs that own their

assets through subsidiaries and that utilize leverage at various entity levels.

Measurement on an unconsolidated basis is problematic for an issuer that owns primarily qualifying assets but owns those assets through a highly leveraged entity. For example, if a mortgage REIT (i) indirectly owned \$500 million of qualifying assets through a subsidiary that had borrowed \$400 million and owned no other assets, and (ii) directly owned \$100 million of real estate related assets, then the issuer would not satisfy Section 3(c)(5)(C) because its qualifying assets would be considered worth only \$100 million on an unconsolidated basis. If in the foregoing example the subsidiary owned both qualifying and nonqualifying assets, then the SEC would measure Section 3(c)(5)(C) compliance by allocating the \$100 million value of the subsidiary in proportion to the subsidiary's ownership of qualifying and nonqualifying assets. Note, however, that if the issuer owns its qualifying assets directly rather than through a subsidiary, the value of those qualifying assets will not be offset by any indebtedness incurred by the issuer to acquire such assets. Therefore, whether assets are held directly or by a subsidiary and whether leverage is incurred directly or by a subsidiary can have significant ramifications under Section 3(c)(5)(C). Those issuers who are in danger of failing to qualify for the Section 3(c)(5)(C) exemption can improve their position by borrowing money to acquire and hold good assets directly.

Treatment of Joint Ventures

When a mortgage REIT's assets are held through other than wholly owned entities, Section 3(c)(5)(C) compliance involves another layer of analysis. For example, if a mortgage REIT owns 10 percent of the equity interest in a partnership and the REIT is not the general partner, it is clear that none of the value of those limited partnership interests will count as qualifying assets, regardless of the nature of the assets held by the limited partnership. In order for any portion of the value of an issuer's interest in another entity to count as a qualifying asset, either (i) the issuer must own at least 50 percent of the "voting securities"¹⁵ of the entity,¹⁶ or (ii) the issuer must serve as the general partner or managing member of a entity and be actively involved in the management and operation of the venture, or at least its agreement must be required for all major decision affecting the venture.¹⁷ If the issuer meets those tests, then the value of its interest in the entity will generally be allocated among qualifying assets, real

estate related assets and miscellaneous assets in proportion to the entity's ownership of such assets.¹⁸

'40 Act Compliance for Most Public Nontraded REITs Today

A hybrid REIT with substantial real estate investments will generally find compliance with Section 3(c)(5)(C) easier than a mortgage REIT holding substantial investments in more than just whole mortgages. Given that the vast majority of public nontraded REITs own primarily interests in real estate, Section 3(c)(5)(C) compliance should not be a major limitation with respect to their ability to invest in debt obligations. This is especially true for larger REITs, which are less likely to own their real estate through joint venture arrangements.

Taxation of Mortgage REITs

REIT tax qualification issues for public nontraded mortgage REITs generally mirror those of publicly traded mortgage REITs.

REIT Qualification Tests

All REITs must meet certain organizational and operational tests in order to maintain their REIT status under the Code. Although most of these rules are beyond the scope of this article, the gross income tests and asset tests applicable to mortgage REITs are of particular importance, and are discussed in detail below after a brief overview of the organizational and distribution tests. Given the variety of debt instruments in which a mortgage REIT might invest, these income and asset test qualification issues can be more complicated for mortgage REITs than equity REITs.

Organizational Requirements

The Code defines a REIT as a corporation, trust or association:

- (1) that is managed by one or more trustees or directors;
- (2) the beneficial ownership of which is evidenced by transferable shares or by transferable certificates of beneficial interest;
- (3) that would be taxable as a domestic corporation but for the Code provisions applicable to REITs;
- (4) that is neither a financial institution nor an insurance company;

- (5) the beneficial ownership of which is held by 100 or more persons during at least 335 days of a tax year of 12 months, or during a proportionate part of a tax year of less than 12 months;
- (6) in which, during the last half of each tax year, not more than 50 percent in value of the outstanding stock is owned, directly or indirectly, by five or fewer "individuals" (as defined in the Code to include certain entities such as private foundations);
- (7) that meets other tests including those described below, with respect to the nature of its income and assets and the amount of its distributions; and
- (8) that makes an election to be a REIT, and the election has not been terminated or revoked.

Conditions (1) through (4) must be met during the entire year. Conditions (5) and (6) do not apply to the first tax year for which an election is made to be taxed as a REIT.

Annual Distribution Requirements

A REIT is subject to two somewhat overlapping distribution requirements. Under the first requirement, a REIT must distribute dividends (other than capital gain dividends) to its stockholders in an amount at least equal to the sum of 90 percent of its "REIT taxable income" (computed without regard to the deduction for dividends paid and net capital gains) and 90 percent of the net income (after tax), if any, from foreclosure property less the sum of specified items of noncash income that exceeds a percentage of its income.

Of particular importance to mortgage REITs, certain "excess noncash" income can be excluded from the distribution requirement. Specifically, to the extent original issuance discount (OID)—along with certain other forms of noncash income such as cancellation of indebtedness income exceeds five percent of REIT taxable income, it need not be currently distributed. Relaxed distribution rule notwithstanding, however, any such undistributed income remains subject to corporate income tax in the hands of the REIT.

Under the second distribution requirement, a REIT must distribute during each calendar year at least the sum of (i) 85 percent of REIT ordinary income for such year, (ii) 95 percent of REIT capital gain net income for such year and (iii) any undistributed taxable income from prior periods, or it will be subject to an excise tax of four percent on the excess of such required

distribution over the sum of (i) the amounts actually distributed and (ii) the retained income on which the REIT has paid income tax.

REIT distributions must generally be paid in the tax year to which they relate. Also, if distributions are declared in October, November or December to stockholders of record in the final calendar quarter of the year, and are actually paid before the end of January of the following year then these distributions will be treated as both paid by the REIT and received by each stockholder on December 31 of the year in which they are declared. Note that most public non-traded REITs declare dividends daily, with payment occurring either monthly or quarterly.

Deduction for Dividends Paid

A REIT avoids tax on its distributed income through the allowance of a deduction for dividends paid. In order for distributions to give rise to a dividends paid deduction, the distributions must not constitute "preferential dividends." A dividend is not preferential if it is *pro rata* among all outstanding shares within a particular class and is in accordance with the preferences among different classes of stock set forth in the REIT's organizational documents.

Various private letter rulings have allowed public REITs to give shareholders making an investment in REIT shares *via* a dividend reinvestment plan a five-percent discount from market price without creating an impermissible preference, and nontraded REITs typically do the same.¹⁹ However, as there is no "market price" for a public, nontraded REIT's shares, these REITs compute the five-percent (or less) discount by using their current or most recent offering price as a proxy for fair market value.

If a REIT distributes less than 100 percent of its "REIT taxable income" (subject to certain adjustments), then it will be subject to tax at ordinary corporate tax rates on the undistributed portion of such income. A REIT may also elect to retain its net long-term capital gains and pay tax on such gains.

If there is a "determination" that a REIT did not distribute sufficient income for any tax year, a REIT may cure such failure with a "deficiency dividend."²⁰ Even though such a deficiency dividend is by definition paid in a later year, it may be included in the deduction for dividends paid for the earlier year. In such a case, the REIT may be able to avoid losing REIT qualification and being taxed on the amounts distributed as deficiency dividends. However, an

interest charge will be imposed on a REIT making deficiency dividends.²¹

Mortgage REIT Gross Income Tests

A REIT must annually satisfy two gross income tests.²²

First, at least 75 percent of a REIT's gross income for each tax year, excluding gross income from "prohibited transactions," must be derived from investments relating to real property or mortgages on real property,²³ including (i) "rents from real property," (ii) dividends received from and gains from the disposition of shares of other REITs, (iii) interest income derived from mortgage loans secured by real property (including many forms of MBS and certain mezzanine loans), and (iv) gains from the sale of "real estate assets,"²⁴ as well as income from certain temporary investments.

Second, at least 95 percent of a REIT's gross income in each tax year, again excluding gross income from prohibited transactions, must be derived from some combination of income that qualifies under the 75-percent gross income test described above, as well as other dividends, other interest and gain from the sale or disposition of stock or securities (none of which need have any relation to real property or mortgages).²⁵

Interest Income

Interest income will generally be qualifying mortgage interest for purposes of the 75-percent gross income test to the extent the debt obligation is adequately secured by a mortgage on real property.²⁶ Conversely, if a REIT receives interest income with respect to a mortgage loan that is fully secured only by looking to both a security interest in real property and a security interest in personal property, and the highest principal amount of the loan outstanding during a tax year exceeds the fair market value of the real property on the date that the REIT's commitment to buy or fund the loan became binding, the interest income will be apportioned between the real property and personal property.²⁷

After performing such allocation, the REIT's income from the debt obligation will qualify for purposes of the 75-percent gross income test to the extent that the interest is allocable to the real property, with interest allocable to the personal property qualifying only for purposes of the 95-percent gross income test.²⁸

Mirroring the rule for contingent rents, interest income contingent only on gross receipts or sales and not the net income or profits of any person is generally acceptable for a REIT.²⁹

Similarly, contingent interest based on the proceeds of a sale of the property securing the loan (e.g., a “shared appreciation” provision) is typically permissible. The income attributable to the participation feature will be treated as gain from sale of the underlying property, and will generally be qualifying gross income under both tests, so long as the property is not inventory or dealer property in the hands of the borrower or the REIT.³⁰

Even mortgage interest based on net income can qualify under both gross income tests, provided the borrower receives “substantially all” of its income from the property from leasing its interest in the property to tenants, but only to the extent that the rental income earned by the borrower would qualify as “rents from real property” had it been earned directly by the REIT.³¹

Many MBS are “regular” interests in REMICs. Any amount includible in the REIT’s gross income with respect to a regular (or residual) interest in a REMIC generally is treated as interest on an obligation secured by a mortgage on real property. If, however, less than 95 percent of the assets of a REMIC are real estate assets (determined as if the REIT held such assets directly), the REIT will be treated as receiving directly a proportionate share of the income of the REMIC.³²

Other MBS are interests in entities viewed as grantor trusts under the “fixed investment trust rules.”³³ In those cases a REIT should be viewed as owning its *pro rata* share of the trust’s assets based on its share of the beneficial interests in the trust.

OID and market discount income that a REIT receives from mortgages or mortgage related securities will usually be qualifying income for purposes of both gross income tests if the interest on the underlying investment is REIT qualified.³⁴

To the extent that a REIT holds debt instruments not secured by real property (or qualifying mezzanine loans), the interest income received with respect to such securities *generally* will be qualifying income only for purposes of the 95-percent gross income test. But see discussion of “qualified temporary investment income” below.

Hedging Activity

Mortgage REITs typically enter into hedging transactions with respect to their assets and liabilities.

Hedging transactions can take a variety of forms, such as caps, swaps, futures, options and forward rate agreements.

Any income a REIT earns from a hedging transaction entered into in the normal course of business primarily to manage risk of interest rate, price changes or currency fluctuations with respect to borrowings made or to be made by the REIT to acquire or carry “real estate assets” will not count as gross income for purposes of the 95-percent gross income test, provided such hedge is properly and “clearly identified.” To meet this test, the hedge itself must be identified as such prior to the end of the day on which it was entered into, and the risk (or item) being hedged against must be specified not more than 35 days after the hedge was entered into.³⁵

Hedging income—regardless of compliance with the above rule—will not typically constitute qualifying income for purposes of the 75-percent gross income test.³⁶

Fee Service Income

Although REITs cannot generally earn “fee service income” that qualifies under the two REIT gross income tests, “loan commitment fees”—an amount paid to the REIT in exchange for agreeing to acquire or make a mortgage loan—will generally so qualify under Code Sec. 856(c)(2) and (3).³⁷

Servicing fees that a REIT earns for servicing mortgage loans that it owns should typically qualify for both gross income tests.³⁸ However, servicing fees for mortgages *owned by third parties* (including a TRS) do not constitute qualifying income under the REIT gross income tests.

Some mortgage REITs originate loans and receive a fee that represents a charge for services as opposed to a charge for the use of money. Such a fee (if not a loan commitment fee) is likewise not qualifying income for the REIT gross income tests.

Qualified Temporary Investment Income

Under Code Sec. 856(c)(3)(I), a REIT’s “qualified temporary investment income” generally counts favorably for purposes of the REIT 75-percent gross income test. Under Code Sec. 856(c)(5)(D), the term “qualified temporary investment income” means any income that is (i) derived from stock or a debt instrument attributable to the REIT’s temporary investment of “new

capital,” and (ii) received or accrued during the one-year period beginning on the date on which the REIT receives such new capital.³⁹ Because any stock or debt instrument acquired with such new capital is, for up to the same one-year period, a *per se* “real estate asset” under Code Sec. 856(c)(5)(B), gain on the disposition of such asset should also be qualifying income (assuming such gain is not “dealer” gain).⁴⁰

“New capital” means, under Code Sec. 856(c)(5)(D)(ii), any amount received by the REIT either in exchange for stock (or certificates of beneficial interests) in the REIT (other than amounts received pursuant to a dividend reinvestment plan) or in a public offering of debt obligations of the REIT that have maturities of at least five years.

As public nontraded REITs are generally raising capital on a daily basis *via* stock sales (until the relevant offering period closes)—as opposed to many publicly traded REITs, which raise capital *via* stock sales (or long term debt) only intermittently—this “qualified temporary investment income” exception can be a powerful tool for such nontraded REITs. Specifically, a nontraded mortgage REIT that is making substantial sales of stock to the public on a continual basis can generally make investments in virtually any sort of debt instrument—secured by real estate or not—and have the income from such asset (the interest and gain) treated as good 75-percent income for up to a 12-month period, subject only to (potentially) prohibited transactions concerns.⁴¹

Short-term loans, in particular, are an attractive investment for nontraded mortgage REITs during the capital-raising period of such a REIT’s lifecycle. Provided such loans are not disposed of in a manner that raises a dealer’s property risk, they will generate good 75-percent REIT income during the 12-month period.⁴²

Additionally, even after a REIT’s capital-raising period has ended, a REIT of any sort may be able to avail itself of the qualified temporary investment income rules through capitalization of subsidiary REITs, although whether the substance of such transactions would be respected is not entirely clear. For example, a REIT not otherwise having “new capital” might capitalize one or more subsidiary REITs as holding vehicles and have such entities purchase or otherwise acquire (with “new capital” received from its shareholder—the parent REIT—in exchange for shares in the subsidiary REIT) short-term (under 12 months to maturity) debt investments. As the subsidiary REIT’s shares and dividends will be *per se* good assets and generate good 75-percent gross

income for the parent REIT, this seems to pose no REIT qualification issues.

The subsidiary REIT will need to comply with the REIT income and asset tests, as well as the various shareholder tests, but this should not be overly problematic or costly. Large REITs often form subsidiary REITs as holding vehicles to address other tax concerns (say, the Washington D.C. unincorporated business tax, or Foreign Investment Real Property Tax Act (FIRPTA) issues for foreign investors looking to own shares in a domestically controlled REIT), and in principle this strategy is no different.

Foreclosure Property

Income from “foreclosure property” can qualify for both gross income tests, even if such income would, absent a foreclosure property election, not have been good REIT income. The rules regarding acquisition, operation and disposition of foreclosure property are complex, and the following is only a brief overview.

Under Code Sec. 856(e)(1), “foreclosure property” is any real property (including interests in real property), and any personal property incident to such real property, acquired by the real estate investment trust as the result of the REIT having bid in such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of such property or on an indebtedness that such property secured.

Foreclosure property includes a building or other improvement that has been constructed on land owned and leased by the REIT and that is acquired by the REIT upon default of the lease of the land.

Foreclosure property doesn’t include property that a REIT takes control of as a mortgagee-in-possession where the REIT cannot receive any profit or sustain any loss with respect to the property except as a creditor of the mortgagor.

Property shall be treated as foreclosure property only if the REIT elects to have it treated as such on or before the due date (including any extensions of time) for filing its return for the tax year in which the REIT acquires such property.

A REIT will generally be taxable on its net income from foreclosure property at corporate rates, but such net income will not include any income from such property that qualifies under the 75-percent gross income test of Code Sec. 856(c)(3).

Additionally, any foreclosure property that would otherwise give rise to a dealer sale will attract tax at only typical corporate rates, and avoid the 100-percent prohibited transaction tax.⁴³

Mortgage REIT Asset Tests

At the close of each calendar quarter, a REIT must also satisfy four tests relating to its assets. First, at least 75 percent of the value of the REIT's total assets must be represented by some combination of real estate assets, cash, cash items, U.S. government securities and, under some circumstances, stock or debt instruments purchased with new capital.⁴⁴ For this purpose, real estate assets include interests in real property, such as land, buildings, leasehold interests in real property, stock of other REITs and certain kinds of MBS and mortgage loans. Of particular importance to mortgage REITs investing in MBS, regular or residual interests in REMICs are generally treated as real estate assets.⁴⁵

MBS

MBS often consist of either pass-through certificates, which provide for a pass-through of the interest and principal payments made by borrowers on the underlying mortgage loans, or collateralized mortgage obligations (CMOs), which divide a pool of mortgage loans into multiple tranches with varying principal and interest payment characteristics.⁴⁶

Pass-through securities can be "straight" or "modified" obligations. A straight pass-through MBS provides the investor with the principal and interest payments in fact collected (less any fees and expenses of the pass-through entity), while a modified obligation may be backed by a guarantee of all or a portion of the interest and principal.

Pass-through certificates that are structured as interests in a grantor trust are generally considered qualifying REIT assets to the extent the issuer itself holds REIT qualifying assets and the interest income from such certificates qualifies for REIT income test purposes.

Mortgage REITs may invest in "agency" MBS. These unrated securities have an implied "AAA" rating because they are guaranteed by the US government (or by a federally sponsored entity). Specifically, entities such as Fannie Mae, Freddie Mac and Ginnie Mae guarantee the payment of principal and/or interest on the MBS.

In general, interest on agency pass-through certificates and other mortgage-backed pass-

through certificates, including any OID, market discount, prepayment premiums, late payment fees and assumption fees (but not including any amounts that represent payment for services) will be considered qualifying income for the REIT gross income tests.

Mezzanine Loans

As noted above, mortgage REITs often invest in mezzanine loans. These are loans secured by equity interests in a pass-through entity that directly or indirectly owns real estate, rather than a direct mortgage on the real property. A safe harbor set forth in Rev. Proc. 2003-65, 2003-2 CB 336 (the "Revenue Procedure"), provides that certain mezzanine loans will be viewed as real estate assets for purposes of the REIT asset tests, and interest earned on the loan by the REIT will be viewed as mortgage interest for purposes of the 75-percent gross income test.

The several requirements of the Revenue Procedure are as follows:

- (1) the borrower is either a partner in a partnership or the sole member of a disregarded entity;
- (2) the loan is nonrecourse, secured only by the partner's interest in the partnership, or the member's interest in the disregarded entity⁴⁷;
- (3) the lender holds a first priority security interest in the pledged ownership interest;
- (4) the security interest held by the lender places its claim ahead of the claims of other creditors of the partner or LLC member;
- (5) the pledged ownership interest cannot be further encumbered except by subordinate interests;
- (6) on any default and foreclosure on the secured loan, the lender will replace the borrower as a partner in the partnership or as the sole member of the disregarded entity, and in the case of a loan secured by a partnership interest, the other partners in the partnership must have agreed that upon such default and foreclosure they will not unreasonably oppose the admission of the lender as a partner;
- (7) on the date the commitment by the lender to make the loan becomes binding on the lender, the partnership or disregarded entity holds real property within the meaning of Reg. §1.856-3(d), and if all or part of this real property is subsequently sold or otherwise transferred, the loan will become due and payable upon the sale or transfer of the real property;

- (8) on each “testing date,” the value of the real property held by the partnership or disregarded entity is at least 85 percent of the value of all of the assets of the partnership or disregarded entity⁴⁸;
- (9) the “loan value” of the real property owned by the partnership or disregarded entity equals or exceeds the amount of the loan⁴⁹; and
- (10) the interest on the loan meets the requirements of Reg. §1.856-5(a) and therefore such interest includes only an amount that constitutes compensation for the use or forbearance of money, and the determination of the amount does not depend in whole or in part on the income or profits of any person (subject to narrow exceptions).

In practice, few mezzanine loans meet all requirements of the Revenue Procedure. Mortgage REITs should proceed cautiously if the “real estate asset” status of a particular mezzanine loan that falls outside of the Revenue Procedure’s safe harbor is important for the REIT qualification tests.

Of course, to the extent a public nontraded REIT is able to rely on the temporary investment of new capital rules discussed above (say, for example, with respect to a short-term mezzanine loan), none of the requirements of the Revenue Procedure are relevant (at least during such period). All that should matter in such a case is that (i) the mezzanine loan be a debt obligation, and (ii) the disposition of such obligation not give rise to a prohibited transaction.

Participations and Junior Interests in Mortgages and Related Assets

Mortgage REITs often acquire less than the entire interest in a mortgage. Such an interest might simply be a share of the entire mortgage, or may be a “junior” or subordinated interest of some sort. In either case, the interest held by the REIT should be a “real estate asset” if the underlying mortgage is adequately secured by real estate and if it otherwise would qualify as a real estate asset if owned entirely by a REIT.

The authority for the position that the relative priority of a mortgage interest is not determinative for REIT asset test purposes is found primarily in private rulings. LTR 8601032 (Oct. 4, 1985), for example, squarely addresses the qualification of participations in mortgage loans as “real estate assets.” Other private letter rulings have reached essentially the same conclusion.⁵⁰

Even absent explicit rulings, the conclusion that a participation in a mortgage asset, subordinated or otherwise, should generally be a good real estate asset seems noncontroversial: a REIT holding a participation in a mortgage either owns an undivided interest in the obligation, a partnership interest in the obligation (which under the “aggregate rule” of Reg. §1.856-3(g) would require the REIT to look through any such partnership to the REIT’s *pro rata* share (based on capital) of the partnership assets), or perhaps even some sort of beneficial interest in a grantor trust of some kind. In short, that a REIT does not own the entire mortgage asset should not change the status of what the REIT does own to something outside the “real estate asset” category.

Qualified Temporary Investment Income Assets

As described above, nontraded mortgage REITs can have extended capital-raising periods, with total offering periods of many years.⁵¹ Any cash a public, nontraded mortgage REIT receives for its shares from the public (other than through a dividend reinvestment plan) should generally constitute “new capital,” which is any amount received by a REIT (i) in exchange for stock in such REIT (other than *via* a dividend reinvestment plan) or (ii) in a public offering of debt obligations of such REIT that have maturities of at least five years.⁵²

“Real estate assets” under the REIT asset tests include any property attributable to the temporary investment of such “new capital” if the property acquired with such new capital is stock or a debt instrument, but only for the one-year period beginning on the date the REIT receives such new capital.⁵³ Accordingly, to the extent a nontraded mortgage REIT acquires any debt instrument with “new capital,” such obligation should automatically count favorably for REIT asset test purposes for the one-year period. Additionally, and as noted above, gains from the sale of real estate assets—other than dealer sales—count favorably for both gross income tests.

Non-Real Estate Assets

Assets that do not qualify as “real estate assets” for purposes of the 75-percent test are subject to additional testing. Specifically, the value of any one issuer’s securities owned by a REIT may not exceed five percent of the value of the REIT’s gross assets. Additionally, a REIT may not own more than 10

percent of any one issuer's outstanding securities, as measured by either voting power or value. Finally, the aggregate fair market value of all taxable REIT subsidiary securities held by a REIT may not exceed 20 percent of the value of the REIT's gross assets.⁵⁴

The five-percent and 10-percent asset tests do not apply to securities of TRSs and qualified REIT subsidiaries. The 10-percent value test does not apply to certain "straight debt" and other excluded securities, as described in the Code, including but not limited to any loan to an individual or an estate, any obligation to pay rents from real property and any security issued by a REIT.⁵⁵ In addition, for these purposes (i) a REIT's interest as a partner in a partnership is not considered a security for purposes of applying the 10-percent value test⁵⁶; (ii) any debt instrument issued by a partnership (other than straight debt or other excluded security) will not be considered a security for purposes of the 10-percent value test if at least 75 percent of the partnership's gross income is derived from sources that would qualify for the 75-percent REIT gross income test⁵⁷; and (iii) any debt instrument issued by a partnership (other than straight debt or other excluded security) should not be considered a security issued by the partnership to the extent of the REIT's capital interest in the partnership.⁵⁸

For purposes of the 10-percent value test, "straight debt" means a written unconditional promise to pay on demand on a specified date a sum certain in money if:

- (1) the debt is not convertible, directly or indirectly, into stock;
- (2) the interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors other than certain contingencies relating to the timing and amount of principal and interest payments; and
- (3) in the case of an issuer that is a corporation or a partnership, securities that otherwise would be considered straight debt will not be so considered if a REIT, and any of its "controlled taxable REIT subsidiaries"⁵⁹ hold any securities of the corporate or partnership issuer that:
 - (a) are not straight debt or other excluded securities (prior to the application of this rule), and
 - (b) have an aggregate value greater than one percent of the issuer's outstanding securities (including, for the purposes of a partnership issuer, the REIT's interest as a partner in the partnership).

After initially meeting the asset tests at the close of any quarter, a REIT will not lose its qualification as a REIT for failure to satisfy the asset tests at the end of

a later quarter solely by reason of changes in asset values. If a REIT fails to satisfy the asset tests because it acquires securities during a quarter, it can cure this failure by disposing of sufficient nonqualifying assets within 30 days after the close of that quarter. If a REIT fails the five-percent asset test, or the 10-percent vote or value asset tests, at the end of any quarter and such failure is not cured within 30 days thereafter, then the REIT may dispose of sufficient assets (generally within six months after the last day of the quarter in which identification of the failure to satisfy these asset tests occurred) to cure such a violation, provided that the excess assets do not exceed the lesser of one percent of the REIT's assets at the end of the relevant quarter or \$10 million.⁶⁰

Financing Mortgage REIT Operations

Mortgage REITs have a number of financing alternatives available to them in addition to traditional credit lines and warehouse lines. Each of these alternatives raises certain tax and commercial issues, as discussed below.

Sales of Loans

A mortgage REIT might originate a whole loan, and then sell either an A-note, B-note or other participation in such a loan.⁶¹ Any loan that will be subdivided in such a manner should be originated (and sold) by a taxable REIT subsidiary if a material amount of gain will be generated in order to avoid the prohibited transaction tax, which could apply if the REIT were viewed as engaging in a dealer sale. Ideally, a "to be sold or subdivided" loan will be originated by the TRS to avoid a situation where the REIT is viewed as the "real seller." If such a loan is in fact originated or acquired by the REIT, it should be transferred to the TRS prior to any sales activity taking place in order to allay assignment of income concerns and bolster the argument that no prohibited transaction arises on the subsequent sale.⁶² The portion of the loan a REIT desires to retain can then be sold by the TRS to the REIT. Transactions between a REIT and its TRS must be at arm's length.⁶³

Securitizations and Related Transactions

Mortgage REITs often conduct securitizations in order to obtain additional leverage. Such securitizations can take the form of "owner-trust" structures, CDOs or REMICs.

A primary constraint on most non-REMIC securitizations is the taxable mortgage pool (TMP) rules. Congress intended the REMIC regime to be the exclusive vehicle for securitizations issuing multiple-maturity mortgage-backed debt securities, and thus the TMP provisions were enacted.⁶⁴ These rules can require a non-REMIC-mortgage holding entity or division that issues debt with two maturities to be taxable as a corporation.

An entity (or portion of an entity) can be treated as a TMP if (i) “substantially all” of the entity’s assets consist of debt obligations and/or interests in debt obligations,⁶⁵ and more than half of these debt obligations are real estate mortgages⁶⁶; (ii) the entity has issued debt obligations with two or more maturities; and (iii) the payments on such debt obligations issued by the entity “bear a relationship” to the underlying mortgages owned by such entity.

A TMP will be *per se* taxable as a corporation, although a TMP that is also a qualified REIT subsidiary under Code Sec. 856(i) (because it is wholly owned by a REIT) will avoid a corporate level income tax.

Owner Trust

One commonly employed financing technique used by mortgage REITs is the so-called owner trust structure. Here, a REIT will contribute mortgage assets to a trust. The REIT will cause the trust to issue debt to third-party investors, and the REIT will retain tax ownership of the mortgages.

In such a structure it is very important that any nominal debt held by any party other than the REIT or its wholly owned disregarded subsidiaries be viewed as debt for tax purposes in order to preserve the trust’s status as a qualified REIT subsidiary (QRS).⁶⁷ This is because the trust will be a TMP under the rules discussed above if it issues debt with more than one maturity (generally speaking), but provided such TMP remains wholly owned by the REIT, corporate tax can be avoided under Code Sec. 856(i), which will essentially convert the TMP to a disregarded entity.

REMIC

Another way of obtaining financing is for a mortgage REIT to create, directly or indirectly, a REMIC. A REMIC is an entity substantially all of the assets of which consist of “qualified mortgages” and certain permitted investments as of the close of the third month beginning after the startup day and at all times thereafter.⁶⁸ An obligation must be principally secured by an interest in real property to be considered a qualified

mortgage.⁶⁹ Further, to be considered a qualified mortgage, these obligations must be transferred to the REMIC on the “startup day” in exchange for regular or residual interests in the REMIC or be purchased by the REMIC within the three month period beginning on the startup day to be considered a qualified mortgage.

A REMIC will issue regular interests and residual interests. Regular interests in a REMIC are treated as *per se* debt for U.S. federal income tax purposes, and holders of these interests must include interest income from the regular interests under an accrual method.⁷⁰ Interest accruals on the regular interests will be deducted by the REMIC in computing its net income. The holders of the residual interests in a REMIC take into account the net income or net loss of the REMIC. A portion of the net income allocated to the residual interest holders may be excess inclusion income.⁷¹ An excess inclusion may not be offset by net operating losses, is treated as unrelated business taxable income (UBTI) by certain tax-exempt organizations, and is not eligible for any reduction in withholding tax (by treaty or otherwise) in the case of a nonresident.

REITs generally use two REMIC alternatives for their financing. In the first alternative, a TRS originates mortgage loans and then sells interests in such loans to a REMIC. The REIT itself will buy a portion of the REMIC interests, with third-party investors buying the remainder. In the second alternative, a REIT essentially capitalizes a REMIC in its entirety, and then obtains financing by entering into a repurchase agreement with respect to the REMIC interests. See *Repurchase Agreements* below.

REMIC structures likely do not work with other than mortgage assets; mezzanine debt, for example, likely is not a “qualified mortgage” for REMIC purposes because such debt is not principally secured by an interest in real property.⁷²

Collateralized Debt Obligations

A CDO structure is an alternative to either an owner trust or a REMIC structure. Here, a REIT will form a wholly owned offshore entity—typically a Cayman Islands entity—that will generally be regarded as a qualified REIT subsidiary because such entity will likely be a TMP and all equity in such Cayman Islands entity will remain owned by the REIT. This entity—often confusingly called the “CDO” itself—will issue multiple tranches of debt to third-party investors. Because the REIT will not typically have made a TRS election for the offshore entity, the CDO vehicle will generate excess inclusion income allocable to the

REIT shareholders. Such excess inclusion income is *per se* UBTI and can be problematic for public nontraded REIT shareholders which are tax-exempt entities (such as IRAs).

Although a REIT might insulate its tax-exempt shareholders from excess inclusion income via a TRS election for the offshore CDO vehicle, such election raises other issues. Specifically, the CDO vehicle will then be a controlled foreign corporation generating significant “Subpart F inclusions.” While the better answer is that such income is qualifying gross income under the 95-percent income test in the same manner as any TRS dividends, this conclusion is not entirely free from doubt. Additionally, the otherwise “good” REIT assets and income from the CDO vehicle mortgage assets will no longer count favorably for the REIT asset and income tests. Finally, a REIT will have to keep the value of all of its securities (other than securities that are “real estate assets” in their own right, such as mortgages or investments of “new capital” as described above) in its TRSs to no more than 20 percent of its total assets.

Repurchase Agreements

Repurchase agreements (“repos”) are simply short-term financing arrangements whereby one party (the borrower) (i) “sells” certain assets to a buyer (the lender), and (ii) agrees to “repurchase” such assets from the buyer at some (generally fixed) point in time.⁷³ For tax purposes, such agreements are generally regarded as secured financings. But if it is important that the REIT retain tax ownership of the assets subject to the repurchase agreement (for example, such asset was acquired with the temporary investment of “new capital” and the qualification of such asset for both the 75-percent asset test and the 75-percent gross income test is important), then extra care should be taken here. Specifically, the repurchase agreement should (i) recite that all parties understand that for tax purposes it is merely a financing and payments under the agreement will be reported consistently with such understanding, (ii) prohibit substitution of purchased assets with other assets (similar or otherwise), and (iii) prohibit the buyer from disposing of the assets during the term of the repo (except in cases of default).

Excess Inclusion Income

If a REIT owns a residual interest in a REMIC or the equity in a TMP, excess inclusion income will likely result.

Excess inclusion income is computed quarterly and equals the excess of (i) taxable income allocable to the holder of a residual interest in a REMIC during such calendar quarter over (ii) the sum of amounts allocated to each day in the calendar quarter equal to its ratable portion of the product of (a) the adjusted issue price of the residual interest at the beginning of the quarter multiplied by (b) 120 percent of the long-term U.S. federal rate (determined on the basis of compounding at the close of each calendar quarter and properly adjusted for the length of such quarter).

A REIT’s excess inclusion income is allocated among its stockholders in proportion to dividends paid.

A stockholder’s share of any excess inclusion income (i) cannot be offset by net operating losses of a stockholder; (ii) is subject to tax as unrelated business taxable income; (iii) is subject to U.S. federal income tax withholding if paid to a non-U.S. person (without reduction pursuant to any otherwise applicable income tax treaty); (iv) is taxable at the REIT level at the highest corporate tax rates to the REIT to the extent allocable to REIT shares held in record name by disqualified organizations (generally, tax-exempt entities not subject to unrelated business income tax, including governmental organizations and, at least under pre-2007 law, to charitable remainder trusts).⁷⁴

Conclusion

Although any REIT seeking to operate as a public nontraded mortgage REIT must comply with the array of securities and tax rules discussed above, the “new capital” exception allows a public nontraded REIT a tremendous advantage during its extended capital raising period, in particular with respect to short-term debt investments. Specifically, a public nontraded REIT that is engaging in regular stock sales to the public is uniquely positioned to efficiently make any number of short-term loans in a REIT-compliant manner, with virtually no tax restrictions on the terms of such loans.

ENDNOTES

* The authors gratefully acknowledge the comments and suggestions of Carrie Hartley and Neil Miller, both of DLA Piper US LLP, and Aameek A. Ponda of Sullivan & Worcester, LLP in preparing this article. Any errors

remain those of the authors alone.
¹ Ernst & Young LLP, *Global REIT Report* (Oct. 2007).
² Note that “mortgages” for these purposes include deeds of trusts and their equivalents,

and it is generally immaterial for REIT asset test purposes whether the underlying real estate is domestic or foreign. Rev. Rul. 74-191, 1974-1 CB 170.
³ Such REITs are also called “unlisted” REITs,

and occasionally (and misleadingly) “private” REITs. See *Private REITs Bloom Amid Property Boom*, WALL ST. J., Feb. 20, 2004.

⁴ See Investment Program Association, *Successful Liquidations Help Fuel DPP Investment to Historic Highs Amid the Credit Market Maelstrom*, Nov. 27, 2007, available online at www.theipaonline.org/IPA%20Feature11292007.htm.

⁵ All “Code Sec.” references herein are to Internal Revenue Code (“the Code”) unless otherwise specified.

⁶ Under Code Sec. 856(l), a REIT may jointly elect to treat a corporation in which the REIT, directly or indirectly, owns stock as a “taxable REIT subsidiary.”

⁷ See Greenwich Capital Acceptance, Inc., SEC No-Action Letter (Aug. 8, 1991); NAB Asset Corp., SEC No-Action Letter (June 20, 1991).

⁸ Northwestern Ohio Building & Construction Trades Found., SEC No-Action Letter (May 21, 1984).

⁹ CBRE Realty Finance, Inc., Registration Statement on Form S-11, Am. No. 6, Registration Statement No. 333-132186 (filed Sept. 26, 2006) at 98.

¹⁰ See Landmark Funding Corp., SEC No-Action Letter (Aug. 21, 1984); Salomon Brothers Mortgage Security, Inc., SEC No-Action Letter (Nov. 8, 1983).

¹¹ JER Investors Trust, Inc., Registration Statement on Forms S-11, Amendment No. 6, Registration No. 333-122802 (filed July 11, 2005), at pages 65–67; see Letter from Quadra Realty Trust, Inc. to Karen J. Garnett, Assistant Director, Division of Corporation Finance, SEC, re: Quadra Realty Trust Form S-11, Registration No. 333-138591 (dated Dec. 15, 2006) at pages 3–4.

¹² *Id.*

¹³ *Id.*

¹⁴ See Capital Trust, Inc., SEC No-Action Letter (May 24, 2007). Note that the issuer in Capital Trust represented to the SEC that the value of the underlying property exceeded the aggregate amount owed under the first mortgage and the mezzanine loan. Conditions 2 and 5 should probably be interpreted to require as much because, in the context of second mortgages as qualifying assets, the SEC requires that the value of the property exceed the principal amount owed under the first and second mortgages. (See NAB Asset Corp., SEC No-Action Letter (June 20, 1991).)

¹⁵ Section 2(a)(42) of the ‘40 Act defines “voting security” to mean “any security presently entitling the owner to vote for the election of directors of a company. However, the SEC Office of the Chief Counsel, Division of Investment Management, stated in Wells Fargo Alternative Asset Management, LLC-Interpretive Letter, File No. 801-60419 (January 26, 2005):

In the context of limited partnership interests, we have

broadly construed a limited partner’s present entitlement to vote for the election of “directors” to include the right to: (1) remove or replace the general partner, (2) vote on the election or removal of the general partner in the event of the general partner’s death, insanity or retirement, (3) terminate the partnership if one of the initial managing general partners ceases to serve in that role, and (4) take part in the conduct or control of the limited partnership’s business. We have stated that a limited partnership interest is a voting security if the limited partner has an economic interest that gives it the power to exercise a controlling influence over the partnership.

¹⁶ See Letter from Quadra Realty Trust, Inc. to Karen J. Garnett, Assistant Director, Division of Corporation Finance, SEC, re: Quadra Realty Trust Form S-11, Registration No. 333-138591 (dated Dec. 15, 2006), at 5.

¹⁷ NAB Asset Corp., SEC No-Action Letter (June 20, 1991).

¹⁸ See Letter from Quadra Realty Trust, Inc. to Karen J. Garnett, Assistant Director, Division of Corporation Finance, SEC, re: Quadra Realty Trust Form S-11, Registration No. 333-138591 (dated Dec. 15, 2005) at 5.

¹⁹ See, e.g., Rev. Rul. 83-117, 1983-2 CB 98, and LTR 9634024 (May 28, 1996). The technical basis for a public, nontraded REIT’s reliance on these private letter rulings issued to publicly traded REITs is amorphous, but nontraded REITs almost uniformly offer no more than a five percent discount from their offering price in their dividend reinvestment plans.

²⁰ A “determination” is one of the following: (i) a decision by the Tax Court, or a judgment, decree or other order by any court of competent jurisdiction, which has become final; (ii) a closing agreement; (iii) an agreement between the REIT and IRS; or (iv) an “identification” by a REIT of the failure to pay sufficient dividends as described in a statement attached to the REIT’s IRS Form 1120-REIT.

²¹ See Code Sec. 860(f)(1).

²² For purposes of the gross income tests, a REIT will be deemed to have earned a proportionate share of the income earned by any partnership in which it owns an interest, determined by reference to the REIT’s capital interest. Reg. §1.856-3(g). A REIT is deemed to have earned the income earned by any qualified REIT subsidiary or other disregarded entity. For these purposes, investment trusts qualifying under Reg. §301.7701-4(a) will also be looked through

as grantor trusts.

²³ Code Sec. 856(c)(3).

²⁴ Only gains are considered for these purposes. See Reg. §1.856-2(c)(1).

²⁵ Note that the exclusion of income from prohibited transactions from both gross income tests means that such income is a threat to REIT gross income tests compliance only to the extent the REIT was counting such income as qualifying income. Note also that “dealer assets” do have any special status under the REIT asset tests discussed below (e.g., a condo project might very well generate prohibited transaction income, but the project is nonetheless a “real estate asset” for purposes of the REIT asset tests).

²⁶ Reg. §1.856-5(c)(1)(i).

²⁷ Reg. §1.856-5(c)(2).

²⁸ Reg. §1.856-5(c). Note that the portion of a loan not adequately secured by real estate loses its status as a “real estate asset” and becomes a security generally subject to the various asset test limitations under Code Sec. 856(c)(4)(B) as discussed below.

²⁹ Reg. §1.856-5(d).

³⁰ See Code Sec. 856(j).

³¹ Code Sec. 856(f)(2)(A) clarifies that the “substantially all” test does *not* consider gains the debtor might have from sales of the property.

³² Given the tax rules applicable to REMICs, it is unlikely the 95-percent threshold will be unsatisfied.

³³ Under Reg. §301.7701-4(c), trusts for which there is no “power to vary” the investment can be treated as grantor trusts and essentially looked through for federal income tax purposes. These trusts are often called “fixed” investment trusts as they are intended to generally be static pools of investment assets, and are looked through as grantor trusts. See, e.g., Rev. Rul. 2004-86, 2004-2 CB 191.

³⁴ See LTR 8640018 (July 30, 1986); GCM 32491 (Nov. 26, 1965).

³⁵ See Code Sec. 856(c)(5)(G). Note however that if hedging instrument constituted a security under the ‘40 Act, any gain or its disposition could arguably qualify under Code Sec. 856(c)(3) as good 95-percent gross income.

³⁶ But if the “hedge” were to also constitute a debt instrument within the meaning of Code Sec. 1275, a qualified temporary investment of new capital position might exist. See discussion below.

³⁷ Code Sec. 856(c)(3)(G).

³⁸ Such “fees” are generally charges for the use of money and not for “services.” See, e.g., Rev. Rul. 80-57, 1980-1 CB 157 (REIT’s income from originating, making and servicing short-term loans all qualified under Code Sec. 856(c)(2) and Code Sec. 856(c)(3) and was explicitly not income from a prohibited transaction under Code Sec. 857(b)(6)). Note that the IRS is contemplating

- revoking this ruling for reasons unrelated to either the qualification of servicing fees as good REIT income or the position that merely making short term loans and holding to maturity is not a prohibited transaction. See proposed regulations under Code Sec. 1221 issued August 7, 2006 (REG-109367-06). Note that the IRS regularly relies on obsolete published rulings for authority regarding REIT income test matters. See, e.g., LTR 200614024 (Dec. 28, 2005).
- ³⁹ The IRS has issued two recent, well-reasoned private letter rulings regarding new capital. In the earlier of these two rulings, LTR 200724031 (Feb. 27, 2007), a REIT that was the successor by merger to a target REIT was allowed to continue to treat “qualified temporary investment assets” as real estate assets until the original, one-year temporary investment period of target REIT expired. In LTR 200740004 (July 3, 2007), a REIT that invested its “new capital” through its operating partnership was still entitled to rely on the “qualified temporary investment of new capital” exception, primarily because of the IRS’ reliance on the aggregate rules of Reg. §1.856-3(g).
- ⁴⁰ Code Sec. 856(c)(2)(H) and Code Sec. 856(c)(3)(H).
- ⁴¹ See LTR 8118047 (Feb. 6, 1981) and LTR 8021110 (Feb. 29, 1980). (REIT’s dispositions of futures contracts on debt instruments including Ginnie Maes were not prohibited transactions on the basis that “securities” traded for one’s own account are not stock in trade, inventory or property held for sale to customers in the ordinary course of business, citing to various cases including *Mirro-Dynamics Corp.*, CA-9, 67-1 ustr ¶9324, 374 F2d 14.)
- ⁴² Any concern that merely collecting principal payments implicates a prohibited transaction—regardless of how long or short a term any loan has—seems misplaced. A prohibited transaction should arise, if at all, only on a sale of such a loan. See, e.g., Rev. Rul. 80-57, 1980-1 CB 157; GCM 38090 (Sept. 12, 1979).
- ⁴³ Code Sec. 857(b)(6)(B)(iii).
- ⁴⁴ Note that some “governmental” securities are actually “real estate assets” under Code Sec. 856(c). See discussion of agency MBS below.
- ⁴⁵ Code Sec. 856(c)(5)(E). As noted above, if, however, less than 95 percent of the assets of a REMIC consist of real estate assets (determined as if the REIT held such assets), the REIT will be treated as owning its proportionate share of the assets of the REMIC.
- ⁴⁶ Collateralized mortgage obligations are typically debt not providing a security interest to the holder in underlying real estate, and as such typically do not qualify as “real estate assets” for a REIT. See, e.g., Gary J. Silver-smith, *REMICs, FASITs and other Mortgage Backed Securities*, 741 TAX MGT PORTFOLIO (BNA). (“As indicated above, as with grantor trust pass-through securities, regular and residual interests in a REMIC qualify as real estate assets for REITs as defined in § 856(c) (5)(B). Collateralized mortgage obligations and other mortgage cash flow bonds do not receive such treatment.”)
- ⁴⁷ In order ostensibly to comply with this “nonrecourse” standard, some mezzanine loans are guaranteed instead of being made recourse.
- ⁴⁸ For this purpose a testing date means the close of the first calendar quarter of the lender’s tax year following the date on which the commitment by the lender to make the loan becomes binding on the lender, and the close of each subsequent calendar quarter in which the partnership or disregarded entity acquires any assets other than real estate assets, cash and cash items (including receivables), government securities (within the meaning of Code Sec. 856(c)(4)(A)), or reasonable quantities of equipment and materials customarily used for the maintenance and repair of real property. For this purpose, asset acquisitions by a partnership or disregarded entity include additional partner or member contributions.
- ⁴⁹ “Loan value” is reduced by any liens encumbering the real property, as well as by any other liabilities of the partnership or disregarded entity on the date the commitment by the lender to make the loan becomes binding on the lender. If the real property is owned by a partnership, only the proportionate share of the loan value (determined using the principles of Reg. §1.856-3(g)) attributable to the interest that secures the lender’s loan is taken into account.
- ⁵⁰ See, e.g., LTR 8541047 (July 15, 1985) (REIT retained 10 percent or less undivided participation interests in mortgage loans); LTR 7409240270A (Sept. 24, 1974) (REIT acquired a 67-percent interest in a mortgage loan and it was assumed without discussion that such participation was a good REIT asset); LTR 7103180480A (Mar. 18, 1971) (interest on a mortgage loan participation was good REIT income under the 75-percent gross income test); LTR 7103290150A (Mar. 29, 1971) (ratable participations and subparticipation were good “real estate assets” and generated mortgage interest income). Additionally, more recent private letter rulings (LTR 200226013 (Mar. 21, 2002) and LTR 200225033 (Mar. 21, 2002)) assume without discussion that mortgage loan participations can be good REIT assets. Cf., Code Sec. 860G(a)(3).
- ⁵¹ In general, a public nontraded REIT will file a registration statement for the number of shares the REIT expects to sell in a two-year period, but shares can be sold under that registration statement for up to three years. Thereafter, additional shares can be sold under a “follow-on” registration statement.
- ⁵² Potential “tracing” issues are addressed by simply having a dedicated account for amounts received in sales of shares (other than for dividend reinvestment plan sales).
- ⁵³ While the IRS has offered little gloss to the statute, in LTR 9342021 (July 22, 1993) amounts invested in shares for what was expected to be a “long-term” period were allowed to qualify as “temporary investments” of new capital.
- ⁵⁴ Present here is a subtle and often overlooked distinction: the 20-percent TRS securities limit is such that the fair market value (as determined in good faith by the Board of the REIT) of all TRS securities (generally speaking) must be worth no more than 20 percent of the gross value of all REIT assets. This means the value of stock in a TRS must take into account any debt owed by the TRS, but the value of real estate—for these purposes—is not reduced by an associated mortgage. Additionally, any securities issued by the TRS that qualify as “real estate assets” (i.e., mortgages) are excluded from this 20-percent limit. See LTR 200630010 (Feb. 28, 2006).
- ⁵⁵ Code Sec. 856(m).
- ⁵⁶ Code Sec. 856(m)(3)(A).
- ⁵⁷ Code Sec. 856(m)(4).
- ⁵⁸ See LTR 9514006 (Dec. 30, 1994), LTR 200234054 (Aug. 23, 2002) and LTR 200740004 (Oct. 5, 2007).
- ⁵⁹ The term “controlled taxable REIT subsidiary” means a TRS if the REIT owns directly or indirectly (i) stock possessing more than 50 percent of the total voting power of the outstanding stock of the TRS, or (ii) stock having a value of more than 50 percent of the total value of the outstanding stock of such TRS.
- ⁶⁰ If a REIT fails any of the other asset tests or its failure of the five-percent and 10-percent asset tests is in excess of the *de minimis* amount described above, as long as such failure was due to reasonable cause and not willful neglect, it is permitted to avoid disqualification as a REIT, after the 30-day cure period, by taking steps including the disposition of sufficient assets to meet the asset test (generally within six months after the last day of the quarter in which identification of the failure to satisfy the REIT asset test occurred) and paying a tax equal to the greater of \$50,000 or tax at the highest corporate income tax rate (currently 35 percent) of the net income generated by the nonqualifying assets during the period in which it failed to satisfy the asset test.
- ⁶¹ The “A-note” portion is simply a senior participation in the mortgage with the “B-note” (and/or C-note, etc.) representing the junior position. Subordinated participation interests in whole mortgages are nonetheless real estate assets. See, e.g., LTR 8601032 (Oct. 4, 1985).
- ⁶² See, e.g., *Court Holding Co.*, SCT, 45-1 ustr ¶9215, 324 US 331.
- ⁶³ Code Sec. 857(b)(7)(E) and Code Sec. 482.

Note also that loans from a REIT to its TRS are subject to the earnings, or interest stripping rules of Code Sec. 163(j)(C)(3).

⁶⁴ See Notice 2006-97, IRB 2006-46, 904.

⁶⁵ For these purposes, “substantially all” means at least 80 percent. Reg. §301.7701(i)-1(c).

⁶⁶ “Real estate mortgages” for these purposes is defined very broadly to include even equity interests in entities. Reg. §301.7701(i)-1(c)(3).

⁶⁷ For a general discussion of debt-equity issues, see Boris I. Bittker & James S. Eustice, *FEDERAL INCOME TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS*, at §4.02 (7th ed.).

⁶⁸ See Code Sec. 860G(d)(1).

⁶⁹ A qualified mortgage is essentially any obligation (including participations therein) that is principally secured by an interest in real estate. Code Sec. 860G(a)(3).

⁷⁰ Code Sec. 860B(b).

⁷¹ Under Code Sec. 860E(c)(1)(A), an excess inclusion is, with respect to any residual interest in a REMIC for any calendar quarter, the excess (if any) of (i) the amount taken into account with respect to such interest by the holder under Code Sec. 860C(a), over (ii) the sum of the daily accruals with respect to such interest for days during such calendar quarter while held by such holder.

⁷² Also there seems to be something of a disconnect between the TMP rules and the REMIC rules: “qualified mortgage” is defined relatively narrowly for REMIC purposes, but “real estate mortgages” are described very broadly for TMP purposes. See Reg. §301.7701(i)-1(c)(3).

⁷³ Rev. Rul. 74-27, 1974-1 CB 24, lists five factors indicating that a transaction is a loan, not a sale: agreement of seller to

repurchase; agreement of bank to resell; inequality between purchase price and market value; payment by seller of specified interest on amount paid; and remedies in case of default. *But see* FSA 0478 (Nov. 17, 1993) where the IRS found that a repo resulted in a sale for tax purposes because, among other reasons, the purchasers were entitled to sell the bonds to third parties and thus had the potential for both profit and loss, and were not obligated to sell the bonds back to the seller.

⁷⁴ It is unclear whether the status of a charitable remainder trusts (CRT) as a “disqualified entity” has been altered as a result of the 2006 amendment to Code Sec. 664(c), which allows a CRT earning UBTI to retain its tax-exempt status but imposes a 100-percent tax on the CRT’s UBTI.

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